No. 15,618

IN THE

United States Court of Appeals
For the Ninth Circuit

RICHARD D. LEUSCHNER,
Appellant,

vs.

FIRST WESTERN BANK AND TRUST COMPANY, a California Banking Corporation, and UNITED STATES OF AMERICA,
Appellees.

APPELLANT'S OPENING BRIEF.

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APPELLANT'S OPENING BRIEF.

JURISDICTIONAL STATEMENT.

The appellant Richard D. Leuschner commenced action No. 35,416, for the payment of funds due him on account of support and maintenance as a beneficiary under the terms of a spendthrift trust, in the Superior Court of the State of California, in and for the City and County of San Francisco. (R. 299.) The defendants were the First Western Bank and Trust Company and Erida Leuschner Reichert who, with appellant, were the three co-trustees of said spendthrift trust. The First Western Bank filed a cross-complaint against plaintiff, its co-defendant, and

United States of America. (R. 49.) The United States thereafter petitioned for removal to the United States District Court for the Northern District of California, Southern Division (R. 46), and this action was removed thereto pursuant to the provisions of Title 28, United States Code, §1444, in that it was an action brought under §2410, Title 28, United States Code, against the United States in a state court.

The United States of America, as plaintiff, also commenced an action No. 35,398 in the United States District Court for the Northern District of California, Southern Division, pursuant to the provisions of the Internal Revenue Code, Title 26, United States Code, §6332(b), against the First Western Bank, as defendant. (R. 3.) Both cases were consolidated for trial (R. 68), and were tried before Willis W. Ritter, United States District Judge, sitting without a jury. Judgment was entered on March 28, 1957. Notice of appeal was filed April 25, 1957. The jurisdiction of this Court is invoked under Title 28, United States Code, §1291.

STATEMENT OF THE CASE.

Appellant commenced an action in the State Court against the First Western Bank, as trustee, to compel the payment of $6,994, accrued to him since July 1, 1955, as a beneficiary of a trust which provided for the payment to beneficiaries, including appellant, of monthly payments equal to one-half of one per cent of the principal sum of said trust, together with all of the income thereof. A copy of said trust agreement

was attached as an exhibit to his complaint. Said trust agreement additionally provides in part, as follows:

> "Each and every beneficiary under this trust is hereby restrained from, and shall be without right, power or authority to sell, transfer, pledge, mortgage, hypothecate, alienate, anticipate or in any other manner affect or impair his, her or their beneficial and legal rights, titles, interests, and estates in and to the income and/or principal of this trust during the entire term hereof; nor shall the rights, titles, interests and estates of any beneficiary hereunder be subject to the rights or claims of creditors of any beneficiary, and all income and/or principal of this trust shall be transferable, payable and deliverable solely to the beneficiaries as herein provided, and the Trustees may require the personal receipt of any beneficiary as a condition precedent to the payment of any money or other property to such beneficiary."

The Trustees answered that the funds would have been paid to him in accordance with the trust, except for the fact that on July 22, 1955, all funds then and thereafter to become payable to appellant, were claimed by the United States of America under notice of levy in the total amount of $207,665.42. (R. 326 and 329.)

Contemporaneously, the United States of America commenced an action in the United States District Court against the First Western Bank, demanding the payment of all funds accumulating to the account of Richard D. Leuschner, pursuant to its aforesaid

notice of levy, plus a statutory penalty for the alleged failure and refusal of the First Western Bank to surrender said funds.

Both actions were consolidated for trial, and in the course of preparation for trial it was stipulated that when said notice of levy was made it was not addressed to any of the Trustees, but was addressed only to a Trust Officer of the First Western Bank. It was further stipulated that all funds payable to beneficiaries under the trust were deposited in a commercial account and withdrawn by check signed by a Trust Officer of the bank.

The evidence disclosed, without contradiction, and the Court found that on July 22, 1955, when notice of levy was given to the Trust Officer, none of the income or corpus of the trust was due to appellant. (R. 78.)

The Court further found that the rights of the United States of America to collect unpaid income taxes from Richard D. Leuschner, the appellant, must prevail over the provisions of the spendthrift trust, and that it was unnecessary for the Court to determine whether the sum of $750 per month was necessary for the support and maintenance of Richard D. Leuschner (R. 79), although in this connection it was stipulated that had appellant been called upon to testify, he would have testified that $750 per month was necessary for his support and maintenance. (R. 34 and 39.)

The Court made no finding of fact or conclusion of law on the issue raised by appellant's amended

answer that the claim of the United States was barred by the defense of res judicata, and that the United States was estopped from asserting any claim against the funds due to appellant from the spendthrift trust. (R. 30.)

QUESTIONS PRESENTED.

1. Whether, to the extent necessary for support and maintenance, the interest of a beneficiary of a spendthrift trust established under California Law, is subject to levy by the United States, or whether only such excess over and above the amount necessary for a beneficiary's support and maintentance is subject to levy by the United States.

2. Whether the claim of the United States is barred by res judicata, based on the decision of the Referee in Bankruptcy denying to the Trustee in Bankruptcy representing the United States and other creditors, the right to seize, levy on or sequester appellant's interest in said spendthrift trust.

SPECIFICATION OF ERRORS.

1. The Trial Court erred in finding that the rights of the United States must prevail over the provisions of the spendthrift trust.

2. The Trial Court erred in failing to find that \$750 per month was necessary for the support and maintenance of the appellant as beneficiary of the spendthrift trust.

3. The Trial Court erred in failing to find that the claim of the United States was barred under the doctrine of res judicata.

ARGUMENT.

I. THE IMMUNITY OF THE INCOME OF A BENEFICIARY OF A SPENDTHRIFT TRUST NECESSARY FOR HIS SUPPORT AND MAINTENANCE IS NOT DERIVED UNDER CALIFORNIA LAW FROM AN EXEMPT STATUS, BUT IS BASED ON A LIMITED PROPERTY RIGHT. THE RIGHTS OF THE UNITED STATES IN ANY PROPERTY ON WHICH A TAX LIEN OR LEVY HAS BEEN PLACED ARE NO GREATER THAN THE RIGHTS OF ITS DEBTOR. THEREFORE, THE CLAIM AND LIEN OF THE UNITED STATES IS SUBORDINATE TO THE TERMS OF THE SPENDTHRIFT TRUST.

Unlike many jurisdictions which have recognized the validity of spendthrift trusts, the California courts have uniformly held that the interest of a beneficiary therein is a *conditional* property right rather than an unqualified interest exempt from the claims of creditors.

Section 867 of the Civil Code of the State of California provides:

> "The beneficiary of a trust for the receipt of the rents and profits of real property, or for the payment of an annuity, out of such rents and profits, may be restrained from disposing of his interest in such trust during his life, or for a term of years by the instrument creating the trust."

Section 859 of the Civil Code of the State of California further provides:

> "Where a trust is created to receive rents and profits of real or personal property, and no valid direction for accumulation is given, the surplus of such rents and profits, beyond the sum that may be necessary for the education and support of the person for whose benefit the trust is created, is liable to the claims of the creditors of such person in the same manner as personal property which cannot be reached by execution."

One of the leading cases in California construing these sections and establishing that the beneficiary's interest is a property right *limited* by the conditions of a spendthrift trust, is *McColgan v. Walter Magee* (1916) 172 Cal. 182, 155 Pac. 995.

In that case the Court said at page 997:

> "Section 867 of the Civil Code provides that such trusts may be created in the rents and profits of real property, provided the beneficiary is restrained from disposing of his interest therein only during his life or for a term of years. Such trusts in real property are further qualified by the provisions of Section 859 of the Civil Code. *Magner v. Crooks,* 139 Cal. 640, 73 Pac. 585. It has also been held that trusts of similar character may be created in the income of personal property. *Cutter v. Hardy,* 48 Cal. 568. The general doctrine that spendthrift trusts, inalienable by the beneficiary and inaccessible to his creditors during his life or for a term of years, are valid in this state, is well established. *Seymour v. McAvoy,* 121 Cal. 442, 53 Pac. 946, 41 L.R.A. 544.
>
> "The doctrine that property may be made inalienable by such declaration of trust rests upon

the theory that a donor has the right to give his property to another upon any *conditions* which he sees fit to impose, and that, inasmuch as such a gift takes nothing from the prior or subsequent creditors of the beneficiary to which they previously had the right to look for payment, they cannot complain that the donor has provided that the property or income shall go or be paid personally to the beneficiary and shall not be subject to the claims of creditors. * * * In *Seymour v. McAvoy,* supra, referring to the first branch of the proposition above stated, the court said:

" 'There is noting in the policy of the law prohibiting a donor from providing that his bounty shall be enjoyed only by those to whom he intends to extend it, and that the property devoted by him to a trust otherwise valid shall not be diverted from its appointed destination.'

"In Pacific Bank v. Windram, 133 Mass. 175, the court said:

" 'Creditors of the beneficiary have no right to complain that the founder did not give his property for their benefit, or that they *cannot reach a greater interest in the property than the debtor has, or ever had.'* "

* * * * * * *

"In Brown v. Macgill, 87 Md. 161, 39 Atl. 613, 39 L.R.A. 806, 67 Am. St. Rep. 334, the court said:

" 'The theory upon which courts have held restraints upon alienation, etc. valid, is that *the cestui que trust only has what the donor has given him—is the recipient of his bounty—and therefore if the donor has not given him the right to alienate the property, or made it subject to the*

> *payment of his debts, no one has the right to complain.* * * * ' " (Emphasis added.)

The other leading case is *Canfield v. Security First Bank* (1939) 13 Cal. (2d) 1, 87 Pac. (2d) 830, where the Court said at Pages 835-6:

> "At common law, and in some American states, spendthrift trusts are invalid. These jurisdictions hold that it is against public policy to permit a debtor to have the use and enjoyment of wealth while his creditors go unpaid. As opposed to this view, the majority of the American states have recognized the validity of spendthrift trusts, at least within certain limitations, either by judicial decision or by special statute. The general theory of most of these cases seems to be that the donor of property has the right to choose the object of his bounty, and has the right to protect his gift from the creditors of the donee. Occasionally, an additional factor has been emphasized—namely, that *the protection of impecunious beneficiaries is in accord with public policy, at least to the extent of keeping such beneficiaries from becoming public charges.*
>
> * * * * * * *
>
> "Section 859 constitutes a statutory modification—a statutory limitation—on the power to create such trusts. As far as trusts within the purview of the section are concerned, the legislature has determined that the trustor is without power to create any kind of trust—spendthrift or discretionary—that can successfully place the income, except the amount necessary for the 'education and support' of the beneficiary, beyond the reach of creditors of the beneficiary. California

> has thus placed a statutory limitation or restraint on the unlimited power of a donor to give his property to whom he may desire *subject to whatever conditions the donor may want. At the same time, in recognition of the fact that public policy also requires that impecunious beneficiaries should be protected from their creditors so as to prevent them from becoming public charges, the legislature has provided that the amount of income necessary for their 'education and support' shall be free from the claims of creditors.*" (Emphasis added.)

The limited property right theory has received additional recognition in 25 Cal. Jur. 324, Trusts § 174, where the text declares:

> "Where a trust is created for the benefit of another, the beneficiary may be restrained by appropriate provisions of the trust instrument from disposing of his interest or ownership. So far as the beneficiary is concerned, it seems that a provision against alienation is binding and effectual according to its terms, *the theory being that the trustor or testator, having a right to give or withhold the property, may, in giving to the beneficiary the rents, profits or interest, limit the beneficiary's interest or ownership therein by any conditions that he may see fit to impose.* The trustor or testator may also effectually provide that the interest of the beneficiary shall not be subject to the claims of the beneficiary's creditors,—at any rate, to the extent that the rents or income of the trust property are shown to be necessary to the education or support of the beneficiary. Trusts containing such provisions have

> been denominated 'spendthrift' trusts, and their validity has long been recognized." (Emphasis added.)

Although the federal courts are not required under the United States Constitution to enforce state "exemption" statutes which conflict with the United States Constitution and laws duly enacted thereunder, the federal courts must follow and enforce applicable rules of property established by the courts in any state where the property involved is situated.

In *Blair v. Commissioner of Internal Revenue* (1937) 300 U.S. 5, 57 S. Ct. 330, the petitioner assigned to his children certain income which he derived from a testamentary trust established by his father. The United States claimed that petitioner's interest was not assignable because he was the beneficiary of a spendthrift trust. Therefore, the entire income of the trust should be taxed to him. The State Court, however, had held that the trust in question was not a spendthrift trust. In denying the Government's claim, the Supreme Court said at pages 9-10:

> "The question of the validity of the assignment is a question of local law. The donor was a resident of Illinois and his disposition of the property in that state was subject to its law. *By that law the character of the trust, the nature and extent of the interest of the beneficiary, and the power of the beneficiary to assign that interest, in whole or in part, are to be determined. The decision of the State Court upon these questions is final.*" (Citing cases.) (Emphasis added.)

So, in the case at bar, the nature and extent of the interest of Richard D. Leuschner as beneficiary of the spendthrift trust is to be determined by California—not by federal or general law. Since California has established, beyond question, that the beneficiary of a spendthrift trust has only a limited and conditional property right in the trust in so far as it is necessary for his support and maintenance, that decision is final and binding on the federal courts which must follow it.

In *Uterhart v. United States* (1916), 240 U.S. 598, 36 S. Ct. 417, 60 L. Ed. 819, the taxpayer brought a suit for refund of estate taxes paid under a law allowing refund for taxes paid on a contingent interest. The United States Court of Claims denied the refund on the ground that, in its opinion, the interest taxed was not contingent, but vested. In *reversing* the decision, the Supreme Court said at page 603:

> " * * * it is obvious that a judicial construction of the will by a state court of competent jurisdiction determines not only legally but practically the extent and character of the interest taken by the legatees."

Likewise, in our case, the judicial construction placed on a spendthrift trust by California courts with respect to a trust established by a resident of California in property located in California, for the benefit of beneficiaries residing in California, must determine legally and practically the extent and character of the beneficial interest, subject to seizure or levy by the United States.

In *Spindle v. Shreve,* 111 U.S. 542, 4 S. Ct. 522, 28 L. Ed. 512 (1884), a trustee in bankruptcy claimed that he was entitled to subject to bankruptcy proceedings a beneficiary's interest in a spendthrift trust. In denying such claim, the Supreme Court said, pages 547-8:

> "The case has been argued by counsel as if it depended upon, or at least, involved the question whether, upon general principles of equity jurisprudence, as administered in the courts of the United States, the terms of the trust in favor of Charles U. Shreve, under his father's will, exceeded the limits fixed for restraints upon the alienation of property held for the beneficial use of the *cestui que trust,* and its exoneration from the liability to be taken for payment of his debts. *It cannot be doubted that it is competent for testators and grantors, by will or deed, to construct and establish trusts, both of real and personal property, and of the rents, issues, profits and produce of the same, by appropriate limitations and powers to trustees, which shall secure the application of such bounty to the personal and family uses during the life of the beneficiary, so that it shall not be subject to alienation, either by voluntary act on his part or in invitum, by his creditors. The limits within such provisions may be made and administered, of course, must be found in the law of that jurisdiction which is the situs of the property, in case of real estate, and, in cases of personalty, where the trust was created or is to be administered, according to circumstances.* And in determining those limits that law declares how far, and by what forms and modes, the institution of property may be per-

mitted to accommodate itself to the will and convenience of individuals, without prejudice to public interest and policy; by what limitations and instruments its usual incidents may be affected and altered, so as to effectuate the intentions of parties; how far the dominion, implied in the idea of property, may be extended so as to limit the future dominion of those who succeed to its beneficial enjoyment.

"*It follows, therefore, that the judgment in each case must be determined by the positive provisions of the law of the locality which governs it,* and the particular terms of the instrument by which the scheme is framed. And, applied to the circumstances of the present case, the question would be merely, whether, according to the law of Illinois, the terms of the trust, established under the will of Thomas T. Shreve, created an interest or estate in the beneficiary, which, not having been previously conveyed to another, could be taken at law or in equity for payment of his debts, and which, therefore, vested in his assignee in bankruptcy. That question, as we have already shown, so far as required by the case, is answered by the declaration that, as nothing has been assigned to the appellant except what had not been previously conveyed and could lawfully be subjected to the payment of his debts, and as the interest in question was either vested in Buchanan or could not be so subjected, by reason of the positive provisions of the statute of Illinois, to which we have referred, the appellant has shown no right to the relief for which, in his bill, he prayed.

"The decree of the circuit court is accordingly affirmed." (Emphasis added.)

The same reasoning applies to the facts of the instant case. Under California law, the donor had the right to create a spendthrift trust, in which appellant obtained only a limited and conditional right. These limits must be found not in federal law, even though supreme in the field of bankruptcy, but in the law of the State of California, which is the *situs* of the property where the trust was created and is administered. In determining those limits, California law, not federal or general law, declares how far the institution of private property may be permitted to accommodate itself to restraints without prejudice to public interest and policy. It follows, therefore, that the judgment in this case must be determined by the positive provisions of California law. If appellant had only a limited and conditional interest in the corpus and income of the spendthrift trust, then only that limited and conditional interest may be reached by the levy of the United States. California law, and only California law, determines property rights in this situation.

Since under applicable local law, the beneficiary had only a limited and conditional right in the spendthrift trust and income therefrom, the federal government by tax lien or levy could not change, vary or increase that limited interest. It is respectfully submitted, therefore, that the District Court erred in finding that "the right of the United States of America to collect unpaid income taxes from Richard D. Leuschner must prevail over the spendthrift provisions of the agreement of trust * * * " (R. 78-9.)

Moreover, it is equally well established that a federal tax lien and levy attaches to property only to the extent of the delinquent taxpayer's interest therein.

In *United Fidelity & Guaranty Co. v. Miller,* 143 F. Suppl. 941 (D.C. N.C. 1956) a contractor defaulted in the performance of his construction contract. The owner made a check payable to the contractor and his supplier. The contractor at first refused to endorse the check because he claimed it was insufficient. Subsequently, he endorsed it to his bonding company, which still retained the credit when the United States filed a tax lien against the contractor for unpaid unemployment, withholding and Social Security taxes. In rejecting the claim of the government and upholding the claim of the supplier to the funds, the Court said at page 944:

> "Under the Internal Revenue Code, 1954, 26 U.S.C.A., § 6321, it is provided:
>
> " 'If any person liable to pay any tax neglects or refuses to pay the same after demand, the amount * * * shall be a lien in favor of the United States upon all property and rights to property, whether real or personal, belonging to such person.'
>
> "This is the applicable section of the law. Under that section, nothing could be plainer than that a lien for federal taxes extends *only* to property and rights to property, real or personal, which belong to the taxpayer. The statute so provides.
>
> "This construction has been well nigh universally placed upon like circumstances by the courts. (citing cases)." (Emphasis added.)

In the instant case, the federal government's lien and levy extended only to appellant's limited and conditional right in the income of the trust and was subject to the spendthrift provisions thereof.

In *United States v. Winnett,* 165 F. (2d) 149 (C.A. 9, 1947), Winnett borrowed money from Summer. Subsequently, Summer borrowed money from a bank and Winnett guaranteed the loan, but reserved the right to set off what he might be required to pay the bank on his guarantee against what he owed Summer. Thereafter, Summer became insolvent and the United States filed a lien against Winnett's indebtedness to Summer. In spite of that lien, Winnett paid the bank on his guarantee and claimed the right of offset. In affirming a decision allowing such offset, the Court said at page 151:

> "One choosing to reach this chose-in-action belonging to Summer by attachment or garnishment could acquire no greater right against Winnett than that possessed by Summer. *This would hold true even though the sovereign initiated the proceeding.* Under §§ 3672 and 3710 (a) of the Internal Revenue Code, 26 U.S.C.A. Int. Rev. Code §§ 3672, 3710(a), the rights of the Collector do *not* extend beyond those of the taxpayer whose right to property is sought to be levied upon. * * *
>
> *"The determination of what constituted the property of Summer on * * * the date of the asserted lien and priority of the United States, is primarily a matter of state law. * * * The Collector can reach nothing that Summer could not have reached."* (Emphasis added.)

Applying the foregoing reasoning to the facts of our case, the United States, as sovereign, could acquire no greater rights in the income of the spendthrift trust than the beneficiary had. The rights of the beneficiary are a matter of state law. The United States can reach nothing that appellant could not have reached. To the extent that the income and principal of the trust were necessary for appellant's support and maintenance, appellant had no power to dispose of or alienate the same. It follows, therefore, that the United States cannot force the Trustee or beneficiary to dispose of or alienate such funds contrary to or in violation of the terms of such trust. To do otherwise would increase and change appellant's limited and conditional right in the income and corpus of the spendthrift trust.

In *United States v. Bank of United States,* 5 F. Supp. 942 (D.C. N.Y. 1934) the United States served on the bank a warrant for distraint, notice of levy and notice of tax lien against the account of one Dix, who owed the bank far in excess of the balance then in his account. The bank refused to pay the Collector any sum whatsoever. In upholding the bank's contention that by reason of its loan, there was nothing owing to the depositor, the Court referred to New York law to determine the taxpayer's property rights, and further stated at page 945:

> "It is settled law, as shown by the case of *North Chicago Rolling Mill Co. v. Ore & Steel Co.,* 152 U.S. 596, 14 S. Ct. 710, 38 L. Ed. 565, that when one seeks to reach a chose in action owned by one's debtor by garnisheeing it by no-

tice to the obligor thereof, the rights of the garnisher cannot be greater than those of his debtor, i.e., the obligee of the chose in action. This was very clearly stated in the case just mentioned by Mr. Justice Jackson in 152 U.S. at page 619, 14 S. Ct. 710, 717, 38 L. Ed. 565. After discussing some English cases on the question of the rights secured by such a garnishment and quoting from the remarks of some of the Lord Justices in the case of *In re Combined Weighing & Advertising Machine Company,* 43 Chancery Division, 93, 104, 105, 106, in which the effect of a garnishment was under consideration, Mr. Justice Jackson said: 'The proposition here laid down is in harmony with the generally recognized principle that the rights of the garnisher do not rise above, or extend beyond, those of his debtor; that the garnishee shall not, by operation of the proceedings against him, be placed in any worse condition than he would have been in, had the principal debtor's claim been enforced against him directly; *that the liability, legal and equitable, of the garnishee to the principal debtor, is a measure of his liability to the attaching creditor, who takes the shoes of the principal debtor, and can assert only the rights of the latter.*'

"This seems perfectly obvious when one reflects that one has to determine what the person, whose chose in action one is seeking to garnishee, actually has.

"It would be most unfair that a third person, merely by reason of his interposition, *whether he was a sovereign or not,* should be able to change the rights inter sese between the obligor of the chose in action and his obligee, who is the objec-

tive of the levy or attachment." (Emphasis added.)

The conclusion is inescapable that the United States could obtain, at most, only what interest appellant had in the payments due under the provisions of the spendthrift trust. The notice of levy, even by the sovereign itself, cannot change, alter or enlarge those rights. By the terms of the trust, those payments must first be used for appellant's support and maintenance before appellant could derive any other rights therein, subject to the reach of his creditors.

Public policy has been urged as an argument by those supporting the doctrine that the funds derived from a spendthrift trust should not be exempt from a tax lien or levy imposed upon the beneficiary.

The argument is set forth in *Mercantile Trust Co. v. Hofferbert,* 58 F. Supp. 701 (D.C. Md. 1944) and cases cited therein. The foregoing case, and those relied upon therein, however, are completely distinguishable. Assuming for the purposes of argument only, but not conceding, that public policy was opposed to allowing a man who owed taxes to live in luxury on the income, or most of the income derived from a spendthrift trust, the case presented here differs materially therefrom. In the *Mercantile Trust Co.* case, supra, the alternative to allowing the claim of the United States for income taxes was to place all of the funds derived from the spendthrift trust beyond reach. In the *Rosenberg* case (cited therein as *In re Rosenberg's Will,* 269 N.Y. 247, 199 N.E. 206 (1935)),

the alternative was to exempt ninety per cent of the funds derived from the spendthrift trust. Obviously, these cases present facts essentially different from those of the instant case where the only funds placed beyond the reach of the United States are those necessary for and limited to the support and maintenance of the beneficiary. Since the reasoning behind those cases has no application herein, the conclusions therein reached have no validity here.

As a matter of fact, the public policy argument actually favors appellant's position, for it is recognized in *Canfield v. Security First National Bank,* supra, that

> " * * * the protection of impecunious beneficiaries is in accord with public policy, at least to the extent of keeping such beneficiaries from becoming public charges * * * "

Surely the State has the right to protect its own citizens and domiciliaries and keep them from its relief rolls, thereby likewise safeguarding state funds and revenue for other important purposes.

United States v. Canfield, 29 F. Supp. 734 (D.C. Cal. 1939) is not contrary. In that case the court recognized the tax lien and claim of the United States against the funds of a spendthrift trust, but there was no showing there how much of said funds was necessary for the beneficiary's support and maintenance. In the absence of such showing, we concede that all of the funds would be subject to creditors' claims. The United States would be, and in the reported *Canfield* case, supra, was in no different posi-

tion than any other creditor. In the case at bar, however, it was conceded that all of the funds payable to appellant under the terms and provisions of the spendthrift trust were reasonably necessary for his support and maintenance. (R. 167-8.)

The Tenth Amendment to the United States Constitution provides:

> "The powers not delegated to the United States by the Constitution, nor prohibited by it to the States, are reserved to the States respectively, or to the people."

Under the foregoing amendment, the State has always been declared supreme in the matter of property rights.

In *United States v. Barneson,* 339 U.S. 87, 70 S. Ct. 503 (1950), the United States brought an action to declare unconstitutional California Probate Code Section 27, which prevented a California domiciliary from making an unrestricted testamentary gift to the United States, although allowing such a gift to be made to California, its counties and municipal corporations. In upholding the constitutionality thereof, the Supreme Court said at pages 91-2:

> "The *Fox* case (*United States v. Fox,* 94 U.S. 315, 321, 24 L. Ed. 192) is only one of a long line of cases which have consistently held that part of the residue of sovereignty retained by the states, a residue insured by the Tenth Amendment, is the power to determine the manner of testamentary transfer of a domiciliary's property, and the power to determine who may be made benefi-

ciaries. *It would be anomalous to hold that because of an amorphous doctrine of national sovereignty, federal constitutional law reached into a California statute and made impotent that State's restriction on the designation of beneficiaries.*" (Parenthetical material and emphasis added.)

Likewise, in our case, the State has reserved power to recognize limited and conditional rights in property. That is a matter of local law, and since the inception of our federal system, the cases have universally recognized the sovereignty of states over property having *situs* therein. California has recognized only a limited and conditional property right of a beneficiary in a spendthrift trust. The United States cannot, based on a doctrine of national sovereignty or federal supremacy, reach into a local matter and change, alter, modify or interfere with property rights, especially where they are based on sound considerations of state public policy.

The argument has been made that a decision in favor of the appellant will create disuniformity. That argument is completely answered in *Davis Warehouse Co. v. Bowles,* 321 U.S. 144, 64 S. Ct. 474 (1944), where the Supreme Court said at pages 155-6:

> "It is also contended that an interpretation must prevail as matter of principle which will give the exemption a general and uniform operation in all states irrespective of local law. It is, of course, true that uniform operation of a federal law is a desirable end, and other things being equal, we often have interpreted statutes to

achieve it. *But in no case relied upon did we achieve uniformity at the cost of establishing overlapping authority over the same subject matter in the state and in the Federal Government.* When we do at times adopt for application of federal laws within a state a rule different from that used by a state in administering its laws, the two rules may subsist without conflict, each reigning in its own realm. *It is a much more serious thing to adopt a rule of construction, as we are asked to do here, which precludes the execution of state laws by state authority in a matter normally within state power. The great body of law in this country which controls acquisition, transmission, and transfer of property, and defines the rights of its owners in relation to the state or to private parties, is found in the statutes and decisions of the state. The custom of resorting to them to give meaning and content to federal statutes is too old and its use too diversified to permit us to say that considerations of nationwide uniformity must prevail in a particular case over our judgment that it is out of harmony with other objectives more important to the legislative purpose."* (Emphasis added.)

It would be a serious and precedent-shattering decision to override or ignore the long line of well reasoned cases which have held that State law controls the acquisition and transmission of property, and defines the rights of its owners in relation to the state, federal government and private parties. Yet, in order to affirm the decision appealed from, this Court will be required so to do. It is respectfully

submitted that the decision of the District Court is in error and should be reversed.

II. THE CLAIM OF THE UNITED STATES AGAINST APPELLANT'S INTEREST IN THE SPENDTHRIFT TRUST WAS ASSERTED IN BANKRUPTCY PROCEEDINGS BY THE TRUSTEE IN BANKRUPTCY WHO REPRESENTED ALL OF APPELLANT'S CREDITORS INCLUDING THE UNITED STATES. THE DENIAL OF SUCH CLAIM BY THE REFEREE IN BANKRUPTCY IS A FINAL JUDGMENT AND BARS THE REASSERTION OF SUCH CLAIM IN ANY SUBSEQUENT CIVIL PROCEEDINGS.

Prior to the institution of these proceedings, the United States filed a claim in bankruptcy. This claim was entitled to priority as provided in §64 of the Bankruptcy Act. As a creditor of the bankrupt, the United States was represented by the trustee in bankruptcy. In the case of *In re Scott*, 53 F. (2d) 89 (D.C. Mich. 1931), the Court said:

> "Some general considerations relative to the office of Trustee in Bankruptcy are important in the determination of the questions presented. It has long been recognized that he is an officer of the court; that he stand in a fiduciary relation to creditors; *that he represents all creditors* * * *" (Emphasis added.)

To the same effect see:

In re Drucker, 134 F. 43 (C.A. Ky. 1905);

In re Columbia Iron Works, 142 F. 234 (D.C. Mich. 1904).

The Trustee, as the representative of all the creditors, including the United States, attempted to include

in appellant's estate in bankruptcy the assets of and income of the spendthrift trust in which appellant had an interest. The rights of the trustee were predicated on §70 of the Bankruptcy Act which provides, in part, as follows:

> "Title to Property. a. The trustee of the estate of a bankrupt * * * shall * * * be vested by operation of law with the title of the bankrupt * * * except in so far as it is property which is held to be exempt to all * * * (5) property, including rights of action which prior to the filing of the petition he could by any means have transferred or which might have been levied upon and sold under judicial process against him, or otherwise seized, impounded or sequestered * * *"

Obviously, whether the Trustee in Bankruptcy became vested with the interest of appellant as a beneficiary of the spendthrift trust herein, depended on whether such interest was transferable or could have been reached by execution or other process.

In *Allen v. Tate,* 6 F. (2d) 139 (C.A. Mo. 1925), the Trustee in Bankruptcy petitioned to review an order of the District Court, entered by the Referee in Bankruptcy, setting aside an order of sale of the bankrupt's interest in a spendthrift trust. In dismissing the petition, the Court said at page 140:

> "Section 70 of the Bankruptcy Act, as amended * * * provides, among other things, that the trustee shall be invested with the title of the bankrupt to 'property which prior to the filing of the petition he could by any means have trans-

> ferred or which might have been levied upon and sold under judicial process against him.' Whether or not the estate created in the bankrupt * * * was such as would pass to the trustee under the above quoted provision depends upon whether it is such property as could be conveyed by the bankrupt or could be subjected to judicial process against her. *That matter is a question of local law as the administration of the Bankruptcy Act takes note of exemptions and rules of property in the several states.* (Citing cases.)" (Emphasis added.)

Again, in *Jones v. Harrison,* 7 F. (2d) 461 (C.A. Mo. 1925), cert. den. 270 U.S. 652, 70 L. Ed. 781, 46 S. Ct. 351, a Trustee in Bankruptcy filed a petition to sequester for the benefit of creditors the interest of the bankrupt in a spendthrift trust created by the bankrupt's father in his will. In holding that the Trustee in Bankruptcy obtained *no* interest therein, the Court said at page 466:

> "The decision of the trial court is in harmony with the fundamentals of the American Rule. These are, that the testator, as the owner of his property, has a right to bestow it with such restrictions as he sees fit to impose, and that his intent cannot be subordinated to the power of the beneficiary or of his creditors."

In the case at bar, the Trustee in Bankruptcy attempted to include the interest of appellant in the spendthrift trust in appellant's bankruptcy estate, subject to administration. In his petition in bankruptcy and schedules attached thereto, appellant had

claimed his interest in said trust was exempt. The Trustee disallowed the exemption on the theory that the equitable interest of the bankrupt in the spendthrift trust was subject to seizure and levy, even though it could not have been transferred or alienated by him. The bankrupt objected to the Trustee's disallowance and on June 9, 1956, his objection was sustained by the Referee. No appeal was taken from this ruling, and it has long since become final. (Defdts. Exhibit "C", R. 178.)

The question arises, what is the effect of that ruling, and the absence of appeal therefrom?

The issue as to what rights the Trustee in Bankruptcy had in the spendthrift trust was directly presented in appellant's bankruptcy proceedings. The order that the Trustee was not entitled to the administration of appellant's interest in the spendthrift trust was based on all issues that were raised or could have been raised in such bankruptcy proceedings. In *Commissioner of Internal Revenue v. Sunnen* (1948), 333 U.S. 591, 68 S. Ct. 715, 92 L. Ed. 898, the Supreme Court said at page 905:

> "The general rule of res judicata applies to repetitious suits involving the same cause of action. It rests upon consideration of economy of judicial time and public policy favoring the establishment of certainty in legal relations. The rule provides that when a court of competent jurisdiction has entered a final judgment on the merits of a cause of action, the parties to the suit and their privies are thereafter bound not only as to every matter which was offered and

received to sustain or defeat the claim or demand, *but as to any other admissible matter which might have been offered for that purpose.* (Citing cases) * * * But where the second action between the same parties is upon a different cause or demand, the principle of res judicata is applied much more narrowly. In this situation, the judgment in the prior action operates as an estoppel, not as to matters which might have been litigated and determined, but only as to those matters in issue or points controverted, upon the determination of which the finding or verdict was rendered * * * In this sense res judicata is usually and more accurately referred to as estoppel by judgment or collateral estoppel." (Emphasis added.)

To the same effect, see:

Tait v. Western Maryland Ry. Co. (1933), 289 U.S. 620, 53 S. Ct. 706, 77 L. Ed. 1405;

Cromwell v. County of Sacramento (1876), 94 U.S. 351, 24 L. Ed. 195;

Parker v. Westover, 221 F. (2d) 603 (C.A. 9, 1955).

Clearly, the United States, by voluntarily filing a claim in the bankruptcy proceedings for the amount of appellant's unpaid income taxes, appointed the Trustee in Bankruptcy as its representative. For as a matter of law, the Trustee in bankruptcy represents all of the creditors, and all of the creditors are in privity with him, and are bound by proceedings taken or suffered by or against him. In this connection, § 70 (c) of the Bankruptcy Act provides in part, as follows:

> "The trustee as to all property in the possession of, or under the control of the bankrupt at the date of the bankruptcy, or otherwise coming into the possession of the bankruptcy court, shall be deemed vested * * * with all of the rights, remedies and powers of a creditor then holding a lien therein by legal or equitable proceedings * * *, and as to all other property, the trustee shall be deemed vested * * * with all of the rights, remedies and powers of a judgment creditor then holding an execution duly returned unsatisfied."

Clearly, the lien or claim of the United States was no greater or different from the claim of the trustee in bankruptcy under the foregoing "strong-arm" section of the Bankruptcy Act. Nevertheless, the Referee in Bankruptcy decided that the title to the bankrupt's interest in the spendthrift trust was not vested in the Trustee in Bankruptcy, and that the bankrupt's limited and conditional interest under this provision was not subject to levy, seizure or sale. This decision, as we have seen, was binding on all creditors represented by the Trustee, in fact, was binding *in rem*. In *Bracewell v. Hughes,* 214 Iowa 241, 242 N.W. 66, the Court said:

> "That a setting of this property as exempt by the Federal Bankruptcy Act * * * is a *final adjudication against all the world,* see *Lockwood v. Exchange Bank,* 190 U.S. 294, 47 L. Ed. 1061, 23 S. Ct. 751, 10 A.B.R. 107; *McGohan v. Anderson,* 113 F. 115, 7 A.B.R. 641; *In re Bordelon,* 4 F. (2d) 285, 5 A.B.R. N.S. 973; *In re Brown,* 228 F. 533, 35 A.B.R. 826; *Duffy v. Tegeler,* 19 F. (2d) 305, 10 A.B.R. N.S. 148.

> "It must be held, therefore, as against said Trustee in Bankruptcy, and the creditors whom he represented on the date of the approval of the Trustee's report setting off this property * * * it was finally settled as against all parties * * *"

To the same effect see:

Smalley v. Laugenour, 196 U.S. 93, 49 L. Ed. 400, 25 S. Ct. 216;

Evans v. Rounseville, 115 Ga. 684, 42 S.E. 100;

Ross v. Worsham, 65 Ga. 624;

Canada v. C. H. Beasley & Bros., 132 Va. 166, 111 S.E. 251.

Likewise, in the instant case, the decision of the Referee on the precise issue raised, that the interest of the beneficiary was not subject to levy, seizure or sale, and therefore was exempt, was binding on the United States, not only because it was a decision *in rem,* but also because the Trustee specifically represented the United States as one of the bankrupt's creditors. The United States is therefore barred from raising the precise issue in collateral proceedings to seize the interest of the bankrupt in the spendthrift trust. There must be a finality to litigation. If the United States was dissatisfied, it could have intervened in the action, and as intervenor taken an appeal from the Referee's decision. But the United States did not do so. Instead, the United States slept on its rights and permitted the ruling of the Referee to become final and binding upon it.

It is clear that in the absence of an appeal, a Referee's decision is entitled to the effect of res judi-

cata. In *Lewith v. Irving Trust Co.,* 67 F. (2d) 855 (C.A. N.Y. 1933) the creditor filed a claim for rent in the sum of $1000. The Trustee in Bankruptcy opposed the claim. There was a hearing before a Referee, at which time the parties stipulated that the claim might be allowed generally for $850, and pursuant thereto, the Referee allowed the claim. Subsequently, the creditor discovered that he was entitled to priority, and petitioned for allowance of his claim in full. In denying the creditor's petition, Judge Hand said at pages 856-7:

> "* * * there has been a litigation upon issues settled by the decision of a court. Such an allowance has all the substantial elements of a judgment, and has the effect of a judgment; it is res judicata between the parties not only in other suits, but in the bankruptcy proceedings themselves." (Citing cases.)

Thus, in the instant case, the ruling of the Referee that appellant's interest in the trust was exempt, that is to say, not subject to transfer by him, levy, sale, impounding or sequestration, is res judicata between the parties and their privies, including the sovereign.

In *Breit v. Moore,* 220 F. 97 (C.A. 9, 1915) Briet filed a creditor's claim in bankruptcy for the unpaid balance for goods sold and delivered to the bankrupt. The Trustee filed objections thereto. At the hearing, the Referee found that the payments received by Breit were a preference, and refused to allow the claim until Breit returned the amount of the preference. Breit refused to do so, and the Trustee brought

an independent action against Breit. In affirming judgment for the Trustee, the Court said at page 99:

> "Breit was no stranger to the proceedings before the Referee. On the contrary, he presented his claim, contested the preference alleged to have been received by him * * * and then abided by the findings and decision against him. He thus had a trial before a competent officer of his own selection of the issue he now claims the right to have tried by a jury. The conclusive answer is that he is concluded by the adverse decision of the Referee in which he acquiesced."

So, in the case at bar, the United States filed its claim as a priority creditor. The Trustee, representing all of the creditors, including the United States, sought to take title to and possession of appellant's interest in the spendthrift trust. The Referee concluded that the trust was not subject to transfer by the bankrupt, or subject to sale, levy, impounding or sequestration, and denied the Trustee's claim. The Trustee and the United States abided by that decision. Having so acquiesced therein, the United States is concluded thereby and barred from claiming in this suit that it has a lien on appellant's interest in said trust subject to levy and seizure.

In *Hargadine-McKittrick Dry Goods Co. v. Hudson,* 122 F. 232 (C.A. 8, 1903), the plaintiff filed a claim on a judgment against the bankrupt which was disallowed. Subsequently, after the defendant had been discharged in bankruptcy, the creditor brought suit against the bankrupt alleging that its claim had been erroneously disallowed, in that it was based on

fraud and not barred by the statute of limitation, which was the basis of disallowance by the Referee. In affirming judgment for the bankrupt, the Court said at pages 233-4:

> "The plaintiff having voluntarily gone into the Bankruptcy Court, and submitted itself to the jurisdiction of that court, and filed its claim against the bankrupt's estate founded on the judgment here in suit, and the court, having disallowed the claim and entered judgment accordingly, and that judgment remaining in full force and virtue, constitutes a complete bar to this action. It is not material upon what ground the court rested its judgment. It unquestionably had jurisdiction of the parties and the subject matter, and if either party conceived its judgment was for any reason erroneous, the remedy was by appeal, and not by a suit on the same cause of action in another jurisdiction against the bankrupt."

The facts of our case disclose that the United States voluntarily filed its claim in bankruptcy, and submitted itself to the jurisdiction of that court; that the Trustee in Bankruptcy, representing the United States, among others, sought to seize appellant's interest in the trust. The Referee held the interest exempt. Regardless of the grounds upon which the Referee's judgment was based, the effect thereof was to adjudicate that appellant's interest in the trust was not subject to seizure, levy, lien, sale, impounding or sequestration. That judgment has become *final* and is binding on the Trustee and all in privity with him. If the United States or the Trustee in Bankruptcy

believed that the judgment was erroneous for any reason, the remedy was by appeal, and not be a separate suit to seize a portion of appellant's interest in the spendthrift trust, as the United States is now trying to do.

In the leading case of *Clendening v. Red River Valley National Bank,* 12 N.D. 51, 94 N.W. 901, the bank filed a claim showing the receipt of partial payment thereon. The claim was allowed. Subsequently, the Trustee in Bankruptcy brought suit to recover the amount of the partial payments as an illegal preference, and recovered judgment thereon. On appeal, the judgment was reversed. The Court held that the allowance of the claim under bankruptcy law necessarily established that the partial payments were mutual debts and credits and not an illegal preference. The Court said at pages 903-4:

> "Referees are judicial officers clothed with power to adjudicate in the first instance over the allowance or disallowance of claims presented against bankrupt's estate, and their findings are entitled to the respect and credit given to officers acting judicially * * *
>
> "The question which the plaintiff seeks to have us determine has been judicially determined by a tribunal having jurisdiction and is therefore binding on us (citing cases). Whether the Referee intended to decide these questions is not material. As we have seen, they were necessarily involved and were, in fact, determined by his adjudication. Whether his decision was right or wrong we need not discuss. It is sufficient for the purpose of this case to say that the question has

been adjudicated by the order of allowance made by the Referee, and that the same has not been reconsidered by him or reversed by the judge upon a petition for review. If the Trustee was dissatisfied with the adjudication made by the Referee, he had a speedy remedy in Bankruptcy Court upon a petition for review, and also by an appeal from the order of the Bankruptcy Court, if adverse to him.

* * * *

"Every person submitting himself to the jurisdiction of the Bankruptcy Court in the progress of the case, for the purpose of having his rights in the estate determined, makes himself a party to the suit and is bound by what is judicially determined in the legitimate course of the proceeding. A creditor who offers proof of his claim and demands its allowance, subjects himself to the dominion of the Court, and must abide the consequences."

In the instant case, the question which the United States seeks to have decided has already been judicially determined by the Referee in Bankruptcy. When the Referee held that appellant's interest was exempt, he incidentally and impliedly held that it was likewise not subject to levy, seizure or sale by the United States or any other creditor who had filed a claim therein. Whether that decision was right or wrong is not material now. Suffice to say, it is a final adjudication, to which the United States is bound.

In the case of *In re Sterling,* 125 F. (2d) 104 (C.A. 9, 1942), the Referee in Bankruptcy issued an injunction against Bolsa Chica from drilling on its prop-

erty adjoining the bankrupt's property on the ground that such drilling would cause irreparable injury to the bankrupt's estate. Bolsa Chica appeared and claimed the Referee had no jurisdiction to issue such injunction. Nevertheless, the injunction was issued and no appeal was taken therefrom. Subsequently, Bolsa Chica commenced drilling and was certified by the Referee to the District Court as being in contempt. Bolsa Chica moved the District Court for dismissal, which was granted. The Trustee appealed. In reversing the District Court, Judge Mathews said at page 107:

> "No review of the Referee's order was sought or obtained. The time within which such review might have been sought expired long before the contempt certificate was filed. As to Bolsa Chica, therefore, the Referee's order was and is conclusive; for the principles of res judicata apply as well to jurisdictional questions as to other questions, as well to bankruptcy cases as to other cases, and as well to decisions of Referees as to those of Judges." (Citing cases.)

To the same effect see:

Clark v. Milens, 28 F. (2d) 457, 458 (C.A. 9 1928);

Donald v. Bankers Life Co., 107 F. (2d) 810, 812 (C.A. 5, 1939).

In *Maryland Casualty Co. v. United States,* 32 F. Supp., 746 (Ct. Cl. 1940), the plaintiff brought an action against the United States to recover income taxes paid by plaintiff as surety for the taxpayer. The plaintiff alleged that the taxpayer had been ad-

judicated a bankrupt, and that the United States had filed a claim for income taxes in the bankruptcy proceedings; that the Referee had disallowed the claim, and that no appeal had been taken. In allowing plaintiff's claim against the United States, the Court said at page 754:

> "* * * Under the statute and all decisions, the judgment rendered by him (the Referee) was in effect the judgment of a court and was entitled to the same credit and standing. The judgment was not only upon the merits, but entered upon a claim presented in behalf of the United States by a party duly authorized to act for the defendant.
>
> "It may be, as contended by defendant, that it now appears that the decision of the Referee in Bankruptcy was contrary to the actual facts in the case. But if so, there should have been an appearance for the Collector or the defendant before the Referee when the claim was heard, and evidence introduced in behalf of defendant, or at least an appeal taken from the decision. Neither the defendant nor any of its representatives did anything, although opportunity was given for a hearing, and there was nothing to prevent an appeal. Under these circumstances, the decision became final."

Likewise, in the case at bar, the United States could have appeared at the hearing on the determination of appellant's exemptions, to protect its interest. Instead, it permitted the Trustee in Bankruptcy to appear in its behalf and represent it at all stages in those proceedings. Then, when the Referee decided

that appellant's interest was exempt and not subject to levy, sale or seizure, it was incumbent on the United States or the Trustee in Bankruptcy to seek a review thereof, or accept the full consequences of that decision. By failing to appeal or petition for review, the Trustee in Bankruptcy and the United States became bound by the decision even though it might have been wrong. The United States is now bound and concluded thereby.

In *United States v. Guaranty-Trust Co.,* 76 F. (2d) 747 (C.A. 2, 1935), the United States voluntarily appeared in a probate proceeding in which the Probate Court decided that the interest of a beneficiary in a spendthrift trust, and the income derived therefrom, were beyond the reach of a federal tax lien for unpaid income taxes. After this decision, the United States brought a suit in the federal courts for an injunction to restrain the trustees from paying any money to the beneficiary. The United States' petition for an injunction was denied, and the denial was affirmed on appeal. Circuit Judge Augustus Hand wrote the opinion and stated:

> "We must * * * assume that the Government appeared in the Surrogates Court, asked that the income claimed by Rosenberg be applied in satisfaction of tax liens which it had sought to impose, and was denied relief. Under such circumstances, it is not open to us to consider whether the State Courts were right in determining that the lien claimed by the United States was precluded by an exemption granted under the New York law. This question was carefully considered by one of

> the most learned and experienced judges of the State of New York and is *res judicata* as to the question raised in the present suit * * *"

Similarly, in the instant case, the United States voluntarily appeared in bankruptcy proceedings by filing its claim and presenting through the Trustee in Bankruptcy a petition to administer upon appellant's interest in the spendthrift trust. That petition was denied. Under such circumstances, it is not open to the United States District Court or to this Court to determine whether the lien now claimed by the United States was precluded by reason of exempt status or because of a limited and conditional property right in the bankrupt or for any other reason. The question has become res judicata and may not be raised in the present suit, and the claim of the United States Government based upon its notice of levy and demand for payment must be denied.

We respectfully submit that the claims of the United States are barred by the defense of res judicata and that the judgment should be reversed.

CONCLUSION.

For the reasons stated, it is respectfully submitted that the judgment of the District Court should be reversed, that this Court should make its finding based upon the stipulation (R. 34) that $750 is reasonably necessary for appellant's support, and that appellant have judgment against the First Western

Bank & Trust Company for all sums accumulating to his credit, subject to the aforesaid limitation, to wit, that it be paid for appellant's support and maintenance.

Dated, San Francisco, California,
January 18, 1958.

Respectfully submitted,
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(Appendix Follows.)

Appendix.

Appendix